



Interview with Fernando Pindado Cardona, Ernst & Young partner responsible for the insurance sector

«Insurance attempts to give certainty to
uncertain things»

After the scandals in which large North American companies have seen themselves implicated, auditing has gone on to take centre stage as a means of knowing the exact situation of companies and the future possibilities that they have in the market. Experienced auditors have almost a sixth sense when it comes to forecasting future developments. Fernando Pindado is an example of this, and is a veteran auditor specialised in the insurance sector. He brings his authoritative opinion to bear on various matters that are of common interest to all insurers.



Fernando Pindado Cardona was born in San Lorenzo de El Escorial (Madrid) on April 8, 1954. He is married with two children. He was awarded a degree in Economics and Business Administration by the Universidad Complutense de Madrid. He also holds the official titles of Certified Public Accountant and Account Auditor. He has worked for Ernst & Young since 1977 - his whole working life - although when he started the company was called Arthur Young. His distinguished professional career as account auditor specialised in the insurance sector is combined with extensive teaching activities. He has wide-ranging knowledge of the trading activities and the accounts of numerous companies linked to the insurance sector in Spain.

Question: What exactly is an auditor's role?

Answer: It is something as simple as making sure that information provided by companies can be believed by third parties. This information does not necessarily have to be about companies listed on the stock market that need to attract investment. Its object is to give credibility to the financial situation which companies present to all the external parties that have an interest in it: the public, creditors, suppliers, competitors, regulatory bodies, etc.

Q: After more than twenty years of carrying out audits of companies in the insurance sector, what opinion have you built up on the accounts that insurance companies present, are they credible?

A: Yes, of course. When this is not the case they are exceptions that normally end up being known by everyone - as the first people to find out about this situation are the media. However, I have to add that the insurance world presents an added complexity with respect to the other sectors, because everything depends on a blurred line between what is true and what isn't. The degree of uncertainty that exists in the insurance sector is not normal in other activities. The function of insurance and reinsurance is to try to quantify events that are unquantifiable, and give a feeling of reality to these unpredictable events. Another point that should be made is the great effort that the insur-



ance sector makes in order to quickly handle claims - in my experience, in many cases, it acts in the client's favour even when the case is doubtful.

Q: Are the principles of good corporate governance still observed in this competitive world where it seems that anything is acceptable in order to improve the bottom line?

A: Not only are they still observed, but also we find ourselves in the initial phase of a business philosophy that is working towards putting an emphasis on social functions and on the client. This move towards social conscience is stronger now than ever before. It was boosted in Spain after the publication of the Olivencia report, which gave rise to a certain business approach. It also exists in other countries such as Holland, with the Peters report; or in the United Kingdom, with the Cadbury report; or in France, with the Vienot report. Trends move from one place to another very quickly, although they need to be adapted to each market.

Q: What challenges confront the insurance and reinsurance industry?

A: They are not very different from those that it has had historically, but what happens now is that they occur in more complex environments which are more competitive and technological, and which oblige the players to be constantly up-to-date. Basically, the philosophical aspects of insurance continue to revolve around two points: firstly to assess and cover the risk, and sec-

ondly, to act as manager of financial resources. One of the principles of insurance has always been to charge in advance and accumulate funds in order to cover later contingencies; in other words there has always been a financial aspect. It would seem more difficult for insurance to exclusively opt for the role of financial intermediary, because this would alter the principles on which this institution is based. Perhaps the path to be followed will be a convergence of operators on the same client, but each one with a separate role and purpose. This is already happening in those banks that have insurers, and vice versa, and which in addition have stockbroking companies and pension-fund or investment fund managers.

Q: Would this lead us to deduce that there will be a continued blurring of the limits of insurance activity, above all when Brussels gives the green light to financial conglomerates?

A: This amalgamation is happening from the point of view of channels, but not of business. With respect to conglomerates, this still hasn't been defined. But advances are being made which the more aware financial and insurance institutions are putting into practice. No matter how much circumstances change - or people, or insurable objects - it is hard to see that there will be a total mixing of activities because each one has its own objectives. Insurance will always be an instrument with a long-term horizon, based on prudence and safety, which helps to ameliorate uncertainty.

Q: Everything points to the fact that we are still far from completing the process of concentration between companies in the sector in the European Union, how long can this still go on?

A: Until now we have seen how the national leaders in each country, companies like Allianz in Germany, Axa in France, Assicurazioni Generali in Italy or Sistema MAPFRE in Spain, have had as their first objective to consolidate their leadership in their national markets, and then become leading insurers in each one of the other European markets. Having a solid base, first in their home country and then in Europe, helps them in their international presence outside these areas. I believe that the turning point in these consolidation movements will come about with an assessment of whether it is useful to continue doing so from a social welfare point of view. When there start to be problems because of a loss of social welfare due to lack of competition, then the time will come when it will be necessary to think about changing the trend. Also, despite everything that we are seeing, other sectors have shown a proven interest in diversifying activities, and this will bring about new competition situations that will be based more on groups of affinity than on the traditional leadership.

Q: Does the fact of being a mutual suppose any advantage with regard to these concentration processes?

A: It is clear that this initially acts as a shield, but it does not guarantee anything more. The success of a mutual, as with any

AUDITORS AND CONSULTANTS

Q: Cases like Enron in the United States have caused a wave of mistrust with regard to the work carried out by auditors that, through parallel companies, charge for consulting work to the same clients. What you think about all this?

A: Two different things are being confused here. The problem is not that the auditor charges a company fees in order to audit it, but that these fees should be so high that they could lead to a loss of independence. This is never the case in auditing. There can be high fees in consulting, above all in technological consulting, but not in auditing. Two years ago Ernst & Young decided to sell their consulting division to the multinational company Cap Gemini in order to avoid this type of situation. It is now very possible that, first the American regulators, and then the European ones, will force the other large firms to spin off their consulting divisions.



INSURANCE IN THE FUTURE

Q: Would you be prepared to give a forecast of what insurance will be like in 20 years time in Spain and Europe?

A: With the present speed of change it is very difficult to know what will happen in 20 years time. There are obvious features such as the need for security brought about by an increase in hazards and instability in many regards, greater exposure to technological, environmental or social risks, or the ageing of the population. It seems clear that there will be need to concentrate and reduce the number of players in insurance so as to favour internationalisation. In addition to this, profit margins will get tighter. I see a future with large companies which continually make an effort to adapt to the markets and which cohabit with many other niche specialists. But the fundamentals of the business will be the same as they are now. The management and distribution methods will change; they will be more technological and financial, and based more on groups of affinity, etc. But insurance will change at the same rate as the requirements that need to be covered change. The key factors behind change will be the achievement of efficient and flexible business structures, the organisation of sales channels that are shared between financial and insurance products and the securing of a more favourable political and fiscal framework.

Q: How do you see reinsurance after the events of September 11?

A: Reinsurance has an important role in these types of events. There may be some bankruptcies due to solvency problems. However, from my point of view, the important thing is that these events have made companies aware that it is possible for these types of acts to occur. That there can be catastrophic losses where they are least expected. It can also be seen as an opportunity for insurance and reinsurance, because the first consequence was a generalised increase in rates, and this is logical, because to convert the possibility of an event into a certainty means to quantify it, and financing this risk has a cost.

Q: A continual stream of mergers and acquisitions can lead to monopoly situations. Where is the limit of free competition?

A: The yardstick that should be used is consumer welfare. This measure of welfare should include avoiding adverse situations that can occur due to a lack of free competition, in other words, due to the existence of a dominant situation in the market. Currently in Spain five insurance groups have more than 50 percent of the market, of the known market, because business carried out in an environment of free provision of services is not quantified, and this will mean ever-larger figures. As I see things, free competition is guaranteed in the European Union thanks to the "single licence". It will however be a little difficult to know the complete situation affecting the market.

Q: What criteria do the European supervisory authorities use in order to evaluate the results of a merger?

A: They look at it from a public angle, in other words if the merger will mean the disappearance or restriction of competition. Another aspect taken into consideration is consumer protection - whether premiums will be increased or the quality of service decreased, etc.

Q: What is the main difference between the USA and Europe with regard to this?

A: Both monitor these two components, above all in sectors where there is a relationship between the companies that are competing. For example, the level of competition is so high between Coca-Cola and Pepsi Cola that a lack of competition is not even considered. The boundary is not in the number of companies that are competing but in the cultural roots of these companies, and the affinities that they have. Of course, the question of whether there is a dominant position that can exert pressure on prices, etc., is assessed.

Q: What factors influence the merger process?

A: The first is an analysis of the structures: are they comparable, flexible and agile so as to allow the process to advance quickly. A different should be drawn between a merger between big companies or the case when a big company absorbs another smaller one. The second case tends to present fewer problems because the roles are more defined. When the merger is between more comparable companies or groups then it is important that the flexibility that I mentioned exists in reality, because problems can arise when one tries to impose itself on the other. The same occurs with the markets in which they operate, because the sum of the two can mean an immediate enhancement if they are complementary, or it can slow down the process if they replace each other. Another important aspect to be considered is a mutual conviction that the merger will be good for both parties. This tends to facilitate the process enormously.

Q: What procedures are used in reinsurance and insurance auditing in order to detect accumulations of catastrophic risks when two companies merge?

A: The catastrophic risks are delimited. Not all companies cover catastrophic risks, and others do it using a reinsurance umbrella. In these cases it is necessary to see which part of the risk is assumed and which part is ceded. The aim is to find out what the net risk exposure is, above all in the situation where accumulations can be present. We had the opportunity to see a practical case of this last year with the storms on the French coast. In the end the decision taken is more political than theoretical. The cases must be assessed from many points of view, we can see this in the case of the World Trade Centre in New York. Insurance tries to bring certainty to uncertain things, and if you do not have the support of some theory or proven historical analysis of cycles, you are lost. The truth is that in the last three years there have been many losses of large magnitude. Although the companies have large reserves they are recording severe losses.



other company, is in its capacity to mobilise resources and manage them optimally. Spain is a clear example of this, because here mutuals are adapting themselves; they have embraced innovation and are modernising their structures. If this were not the case it would mean their disappearance. The concept of the old mutual is long gone.

Q: Spain is still a country with a large number of insurance companies, where there is still a certain resistance to alliances or mergers. What will be the effects of the Basle agreements, and what has the implementation of the euro meant?

A: Considering the fact that, among other things, the Basle agreements propose greater solvency requirements, it would seem obvious that the concentration processes will accelerate because many players will be below the required financial solvency and economic security thresholds. With regard to this, the Directorate General for Insurance has for some time been working to favour concentration in Spain. With respect to the euro, it seems that our adaptation will in the end be exemplary. This year it will be possible to publish the accounts in euros or in pesetas. Some groups will opt to do so in both currencies, thinking that information given in this way will be clearer, but the majority will do so only in euros.

Q: There are countries in the European Union which have an advantageous fiscal regime, when will this be harmonised?

A: It is not possible to know with precision, but it is clear that this will accelerate appreciably, above all after the entrance of the euro, which will bring about the greater interchange of economic resources between countries. This will cause each state to make greater efforts to retain internal savings and capture savings from other countries. It is precisely this that requires a rapid fiscal harmonisation so that nobody has an unfair advantage in the attraction of resources. ■

News

MEXICO. The Mexican insurance authorities published the new reforms to the Insurance Contracts Act, the General Mutual Insurance Companies and Institutions Act and the Federal Institutions and Deposits Act that came into force in January 2002.

These reforms aim to promote the sector's development and maximise supervision and regulation compliance with international standards.

One of the important aspects of those reforms lies in a number of adaptations in order to strengthen corporate governance of companies and to increase their scope for capitalisation. Insurers will have to have a regulatory comptroller, may increase their capital by issuing debt and may make use of the aid of financial reinsurance schemes.



SPAIN. Spain's Consorcio de Compensación de Seguros and the insurance sector's employers' organisation (UNESPA) have signed an outline agreement to reinsure loss of profits arising from terrorism. As reinsurer, the C.C.S. covers direct losses arising from terrorism (among others) but does not cover consequential losses. It was therefore necessary to establish a reinsurance agreement that was to be voluntary, transitory and exceptional. It is possible that the C.C.S. will include consequential losses within its ordinary insurance scheme, thereby making it necessary to change current legislation.



LOSSES. Last March Munich Re and Swiss Re published their final reports on 2001 catastrophes, providing a estimation of insured losses between USD 11.5 and 10 billion (EUR 13.08 and 11.37 billion) respectively; in both cases being higher than the USD 7.5 billion (EUR 8.53 billion) for the year 2000.

The earthquakes in El Salvador, India (Gujarat), North-East USA (Seattle) and Peru (Arequipa) attracted the public attention during the first half of last year and the Gujarat earthquake with a death toll of 15,000 confirmed victims that attained the sad record of

number of victims. It was however the tropical storm Allison in the North American states of the Gulf of Mexico that triggered the higher overall loss (USD 6 billion, EUR 6.82 billion) together with the largest insured value (USD 3.5 billion, EUR 3.98 billion).

As many previous years, 65% of a total of 700 catastrophes in 2001 were due to storms and flooding, which accounted for 90% of insurers' liabilities. The share of flooding in these figures is due to the victims caused and, to a certain extent, economic losses, since insured losses due to flooding were meaningless for this year.

In geographical terms, Taiwan continues to be shaken by a high level of seismicity in addition to the direct hit of several typhoons. This situation was culminated by typhoon Nari that resulted in an insured loss of USD 600 million (EUR 682.48 million); being the most expensive storm to date in the Taiwanese market.

The United States, due to its size, exposure to all types of natural hazards and concentration of economic values in specific areas, has taken a leading role in many of the catastrophe events in 2001. Violent meteorological episodes, including tornados and severe hailstorms, which in the end mean a significant insured loss, should be added to those already mentioned.

Swiss Re traditionally includes an analysis of man-made losses and although during the Nineties natural catastrophes played the main role, in 2001 - and more specifically after 11 September - out of the USD 34.44 billion (EUR 39.13 billion) which Swiss Re attributes to property insurers for catastrophes in 2001, some USD 19 billion (EUR 21.61 billion) are due to the dramatic occurrences which took place on that day in the United States. This figure might reach some USD 58 billion (EUR 65.97 billion) when all affected lines of business are included.

Always bearing in mind the inherent uncertainty of the Earth seismic behaviour and possible climate changes, the worst possible scenarios must now also include terrorism as a factor that is hard to foresee.